Economic Update

NBK Economic Research Department I 2 August 2021

International Scene

Fresh virus worries dent recovery optimism as US inflation spikes higher

> Economic Research
+965 2259 5500
econ@nbk.com

Highlights

- **Global financial markets were mixed through July with benchmark bond yields lower but equities mostly higher amid a combination of strong but slowing economic data, ongoing pandemic pressures and a tech crackdown in China.**
- **US economic data remains positive but supply shortages, rising prices and a climb in Delta variant virus cases are a cause for concern. The Fed left policy unchanged but the ongoing surge in prices is challenging its 'transitory' inflation thesis.**
- **A rise in Delta virus cases is also a worry for the outlook in Europe, though growth came in at a better-than-expected 2.0% q/q in Q2. The ECB's new symmetric 2% inflation target and forward guidance suggest that rate hikes may be years away.**

Global financial markets experienced a mixed month to late July, digesting a combination of strong but softening economic data, inflation worries, expectations of tighter monetary policy, a tech crackdown in China and of course ongoing virus-linked uncertainty including the worrying spread of the more infectious Delta strain. Benchmark 10-year US treasury yields for example sank to near five-month lows (1.23%) but equity markets outside China (-6%) were mostly higher. In its July update, the IMF offered a reminder that pandemic pressures have by no means disappeared. It left its global growth projection for 2021 unchanged from April at 6%, but upgraded advanced economies (5.6%) and downgraded emerging markets (6.3%) partly reflecting divergences in policy support and vaccine access that will see the pandemic persist in many poorer countries for some time. Meanwhile, despite a temporary mid-July sell-off, Brent oil prices remained well above $70/bbl in late July as markets factored in a continued recovery in global demand plus an agreement by OPEC+ to only gradually ease earlier steep production cuts by the end of next year.

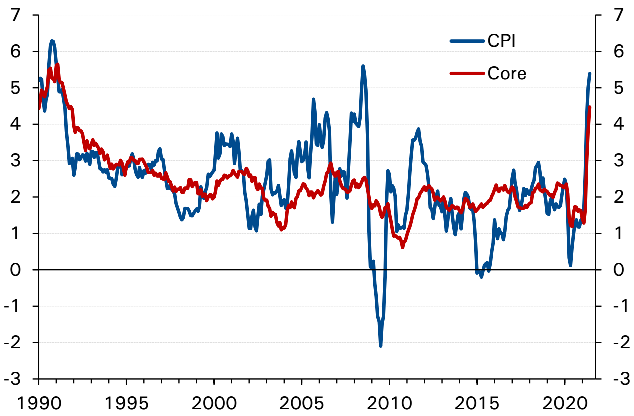
US data still strong, core inflation hits 30-year high

US economic data remains broadly strong, but there are signs that the recovery momentum is slowing amid supply shortages, rising prices (see below) and a renewed surge in Delta variant virus cases that has triggered some tighter health precautions. GDP in Q2 grew at a robust but softer-than-expected annualized 6.5% pace, up from 6.3% in Q1 as pent-up demand aided by reopening and a rebound in consumer confidence boosted household spending. But the PMI fell to 59.7 in July – a four-month low though still consistent with strong growth. And the sluggish labor market recovery continues to provide some cause for concern: new jobless claims hit a 9-week high in mid-July, but the underlying situation remains difficult to interpret due to temporary government support policies and potential short-term frictions from changing patterns of demand.

The Federal Reserve as expected left policy on hold in late July, though conceded that the economic recovery was making progress and that a tapering of its $120 billion per month bond purchases could be on the way in coming months. Chairman Jay Powell continued to play down inflation worries, despite CPI inflation surging to 5.4% y/y in June and the core rate hitting a 30-year high of 4.5% – both overshooting market expectations. (Chart 1.)

Chart 1: US Consumer price inflation

(% y/y)



Source: Refinitiv

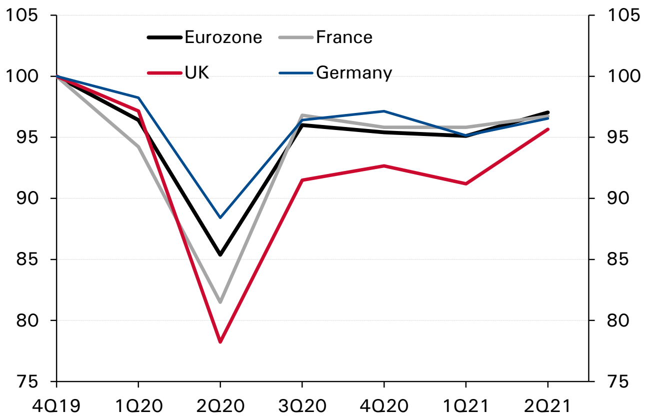
And indeed, much of the current rise has been driven by potentially temporary factors including energy (+25% in June, linked to rising oil prices), used cars (+45%, linked to the chip shortage affecting new car production), and air fares (+25%, lifted by a jump in travel demand) – all consistent with the bank's 'transitory' inflation thesis. But the longer that even temporary or sector-specific price pressures persist, the greater the risk that they begin to feed through to other parts of the economy. Moreover, given the bank's new policy framework which targets inflation running hot for a while, the chances of the Fed mistakenly accommodating a more durable shift in inflationary pressures have undoubtedly risen.

Eurozone recovery proceeds but Delta could weigh

Economic activity in the Eurozone is catching up with the US, though the recent climb in Delta variant cases is starting to cause some concern especially given the potential impact on the summer tourist season. GDP growth in 2Q21 was stronger than expected at 2.0% q/q – actually faster than in the US, although output remains 3% below pre-pandemic levels. (Chart 2.) While growth in principle has scope to accelerate given the scale of the previous recession, a large virus wave that triggers either fresh restrictions or more precautionary behavior could eat into the rebound anticipated for H2. The flash composite PMI hit a 21-year high of 60.6 in July including a climb to 60.4 for services, as earlier reopening measures led to a surge in demand and boosted hiring. However, given the latest virus trends this could represent a near-term peak, and indeed firms' optimism on the year ahead slid to its lowest since February.

Chart 2: GDP in Europe

(index, 4Q19 = 100)



Source: Haver / third party forecast for UK for 2Q21

The European Central Bank left its main policy tools on hold as expected in July, with the deposit rate at -0.5% and a PEPP asset purchase target of €1.85 trillion by end-March 2022. The meeting was the first after the bank announced a change in its inflation target from the previous 'close to but below 2%' to a symmetric 2% objective. The adoption of a slightly higher inflation target in principle affords scope for the bank to loosen policy further, though in practice with policy already highly accommodative the scope to do so in the near term was somewhat limited. The bank did however set out new forward guidance, announcing that inflation would have to reach its target 'well ahead' of the end of its 3-year forecast horizon before interest rates could rise. With inflation currently projected by the bank to reach 2% by 2024 at the earliest, this means that the first hike in interest rates may not occur until the second half of the decade.

In the UK, with 70% of all adults now fully vaccinated the government lifted many virus-related restrictions on July 19th, despite a surge in (Delta variant-led) infections close to the peak levels recorded in January – although these have since receded. Economic activity should benefit, though ongoing voluntary precautions, work absences caused by the still-present contact-tracing scheme and a potential lagged climb in infections triggered by the reopening may yet weigh on a full economic recovery. GDP rose 0.8% m/m in May and could rise by a very strong 5% q/q in 2Q21 overall, but would remain 4% below pre-crisis levels. Meanwhile, inflation jumped to an above-target 2.5% y/y in June. While some members of the Bank of England's Monetary Policy Committee are signaling growing concern over rising prices, a scaling back of the bank's QE program is likely to wait until the impact of the end to the government's furlough program in September is more evident.

Japan's economy strained as Olympics begin

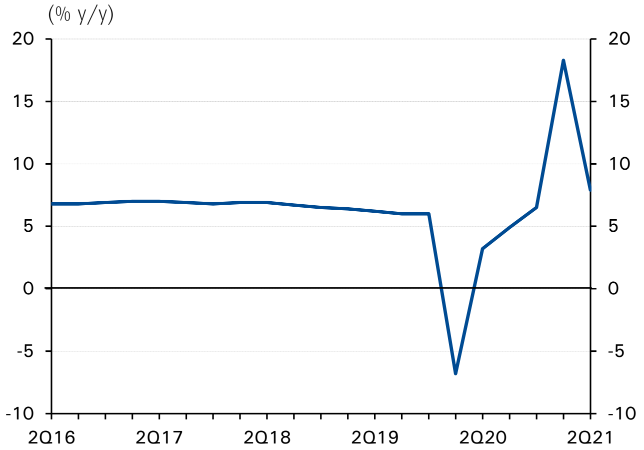
Japan's economy is struggling to shake off the drag from the pandemic after the government imposed "quasi-emergency" measures in Tokyo and other major cities to limit the spread of the disease amid an increase in infections: country-wide case numbers doubled in the week to July 27, with 7,619 new infections reported. Only about 23% of Japan's population has been fully inoculated amid a much slower than anticipated vaccination drive. The delayed Olympics began in mid-July amid extensive precautionary measures including no spectators (and much public opposition) and in the circumstances the economic boost from the games is likely to be limited.

GDP fell by 1.0% q/q in Q1 and although may have risen 0.4% in Q2, growth remains under some pressure. The flash composite PMI for July fell to 47.7 from June's already soft 48.9, with services at just 46.4 as restrictions to curb the virus remained in place throughout the month. More encouragingly, exports rose 49% y/y in June, the fourth straight month of double-digit gains and supporting hopes for an export-led recovery, although still skewed by a base effect from pandemic-induced weakness last year. Meanwhile, in its monthly economic report for July, the government kept its overall assessment unchanged from June with ongoing pandemic pressures likely to continue to cause disruptions in economic activity until the latest wave of infections passes and restrictions are lifted.

Chinese economic growth moderates

In China, amid renewed concerns over the pandemic situation, the reintroduction of travel restrictions in some provinces, and worries over the business impact of surging commodity prices and supply chain disruptions, recent data have revealed further signs of a moderating economic recovery. With a rise of 1.3% q/q, GDP rose 7.9% y/y in 2Q21 after a record of 18.3% in the previous quarter, and below expectations of 8.1%. (Chart 3.) In addition, retail sales growth decelerated in June to its weakest since December (+12.1% y/y), while Industrial output rose 8.3% y/y, the lowest rate in 6 months but above market forecasts, as consumption and production moderated during the latest Covid outbreaks.

Chart 3: China GDP



Source: Refinitiv

Meanwhile, the central bank decided to cut the required reserve ratio (RRR) by 0.5 percentage points from July 15. This decision is expected to release long-term capital of about 1 trillion yuan ($154.4 billion) to help consolidate the economic recovery. The surprise RRR cut has fueled speculation about further monetary easing; however, the central bank kept policy rates steady for the 15th consecutive month at its July 20 meeting. The regulatory authorities have also caused international consternation with the ongoing crackdown on some private education and also larger technology firms, whose market valuations have suffered, and which may result in overseas investors attaching greater risk to Chinese assets.

India's recovery should benefit as Covid wave subsides

In India, following the severe virus surge that pushed new infections to above 400,000 per day in May, cases have since declined considerably to around 38,000 as of late July and the (first dose) vaccination rate has progressed to 25% of the population. These developments are a promising sign that the economic recovery that started early in the year could regain traction. Various indicators still pointed to weakness in June, such as reported wage cuts and continued job shedding, and weak demand, reflected in the composite PMI, which fell further into contraction to 43.1 from 48.1 in May. In view of these negative developments, the IMF in July slashed India's GDP growth projection for FY2021/22 to 9.5% from 12.5% in the April estimate.

We expect forthcoming near-term data to paint a gradually more upbeat picture, as an improved Covid scene and easing mobility restrictions promote a pickup in confidence, employment, wages and demand, helping to restore recovery momentum. Indeed, the Refinitiv-Ipsos consumer confidence index rose modestly in both June and July signaling improved conditions. With that said, downside risks remain due to still high inflation (6.3% in June), limited policy space and high government debt levels (around 89% of GDP in 2020 according to the IMF), in addition to inevitable virus uncertainty.

Head Office

Kuwait
National Bank of Kuwait SAKP
Shuhada Street,
Sharq Area, NBK Tower
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2242 2011
Fax: +965 2259 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Jordan
National Bank of Kuwait SAKP
Amman Branch
Shareef Abdul Hamid Sharaf St
P.O. Box 941297, Shmeisani,
Amman 11194, Jordan
Tel: +962 6 580 0400
Fax: +962 6 580 0441

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 2277
Fax: +44 20 7486 3877

France
National Bank of Kuwait France SA
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
34h Floor, NBK Tower
Shuhada'a street, Sharq Area
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353